Merlon Australian Share Income Fund

Webinar – 31 October 2019

Hamish Carlisle, Adrian Lemme and Joey Mui

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How Merlon's Approach is Different

MERLON CAPITAL PARTNERS

Fundamental Research

Focused on sustainable cash flow

Portfolio Diversification

No reference to ASX200 weights

Downside Protection

Through research & hedge overlay

This focus on capital preservation and growth delivers

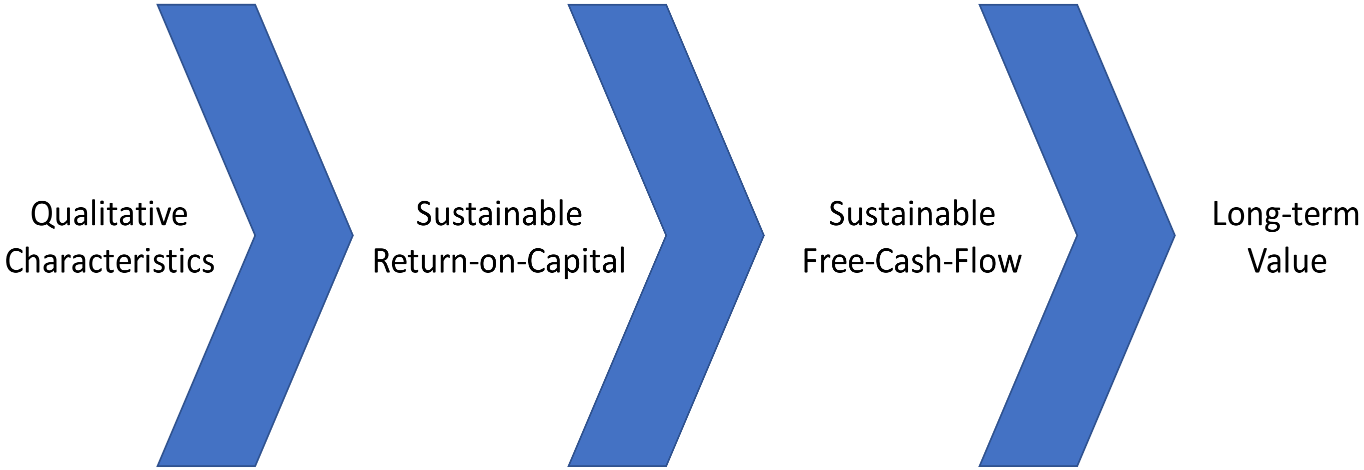
Sustainable Income

Paid monthly and majority franked

Outline

- Quality in the Merlon process
- Why Telstra could be worth less than $2
- Fund positioning and performance

Linking Quality and Value

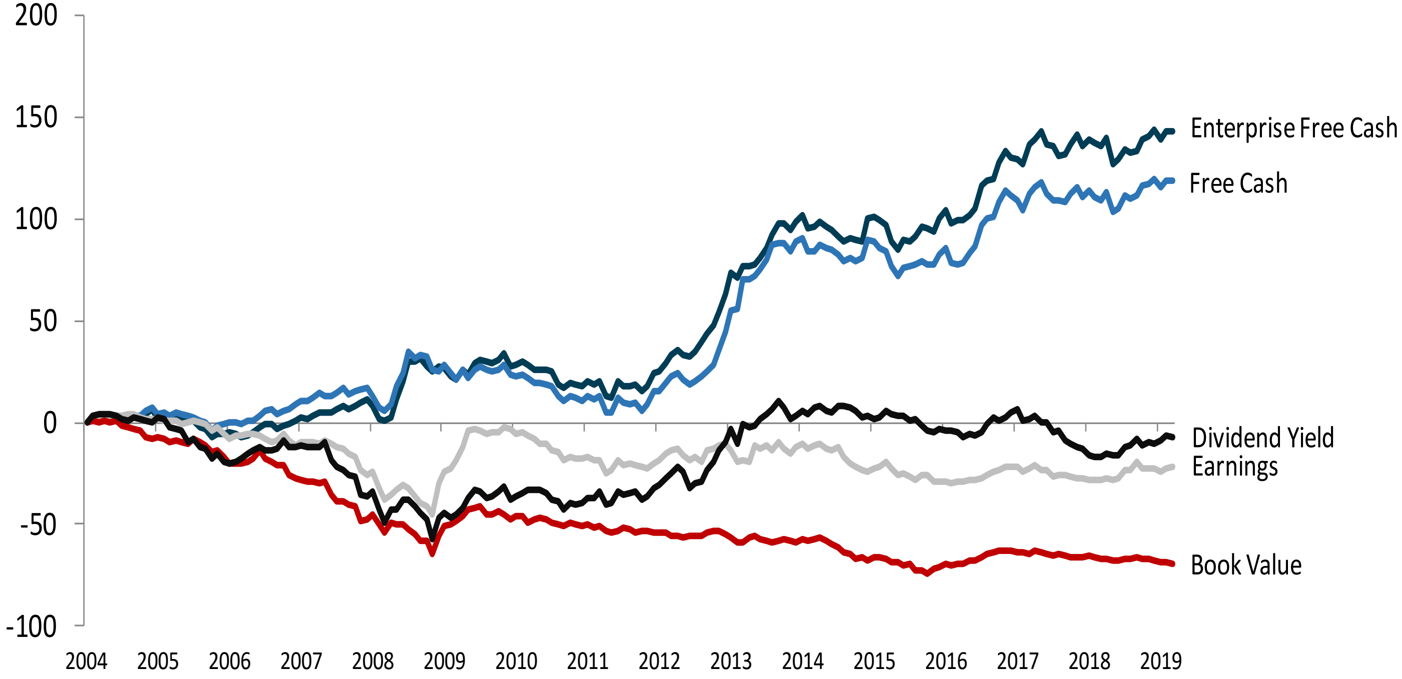


Source: Merlon Capital Partners

- Qualitative characteristics drive sustainable returns on capital
- This in turn underpins the **sustainability** of future free-cash-flows
- Ultimately, Sustainable Free-Cash-Flow is used to form our assessment of long term value

Merlon's Investment Philosophy

Returns – "Value" Portfolios Relative to "Glamour" Portfolios[1]



Source: Merlon Capital Partners/ Bloomberg, Australian Data, March 2004 to June 2019

- Investing in companies that have a history of strong free cash flow relative to the stock price have outperformed over time
- We aim to outperform the market by investing in companies that are undervalued relative to our assessment of their long term sustainable free-cash flow

1 Portfolios are formed using four valuation ratios: free-cash-flow-to-price (F/P); enterprise-free-cash-flow (EF/EV); earnings-to-price (E/P) and book value-to market (B/M). Portfolios are formed at the end of each month by sorting on one of the four ratios and then computing equally-weighted returns for the following month. The "value" portfolios contain firms in the top one third of a ratio and the "glamour" portfolios contain firms in the bottom third. The analysis is based on S&P/ASX200 constituents and the raw data is from Bloomberg

Merlon's Investment Process

Source: Merlon Capital Partners

- **Valuation** and **Conviction** are key research outputs used to determine our portfolio weights, subject to risk and liquidity constraints

Merlon's Investment Process – Valuation & Quality

- **Assessing Qualitative Characteristics**

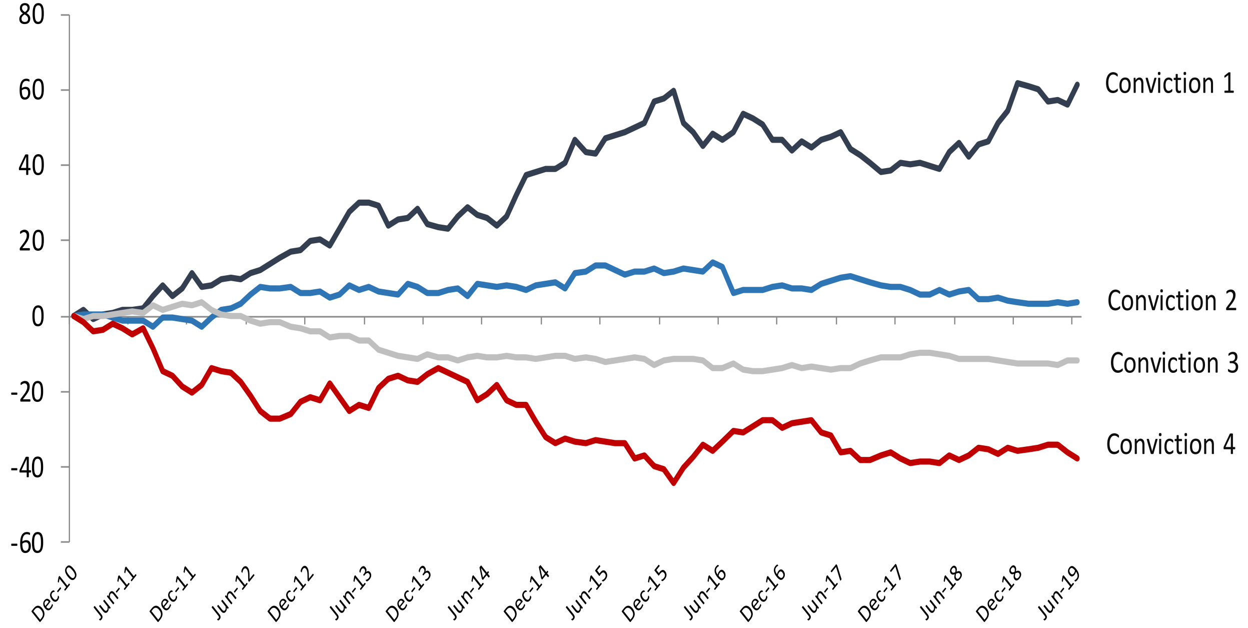
1. Industry Structure
2. Competitive Advantage
3. Governance and Management

- **Earnings Quality**
- **Balance Sheet Quality**

• All analysis and assessments of qualitative characteristics are <u>quantitatively</u> measured and integrated into our valuations

Merlon's Investment Process – Conviction & Quality

Total Returns by Merlon Conviction score 2010-2019



Source: Merlon Capital Partners/ Bloomberg/ Goldman Sachs Research , June 2019.
Past performance is not a reliable indicator of future performance.

- Conviction Scores reflect the degree of market misperception around a company's prospects
- The market can misunderstand the inherent quality of a business which influences our Conviction Score
- Often the market misattributes poor quality from a business segment to the entire company
- A high-quality segment can underpin our "bear case" valuation

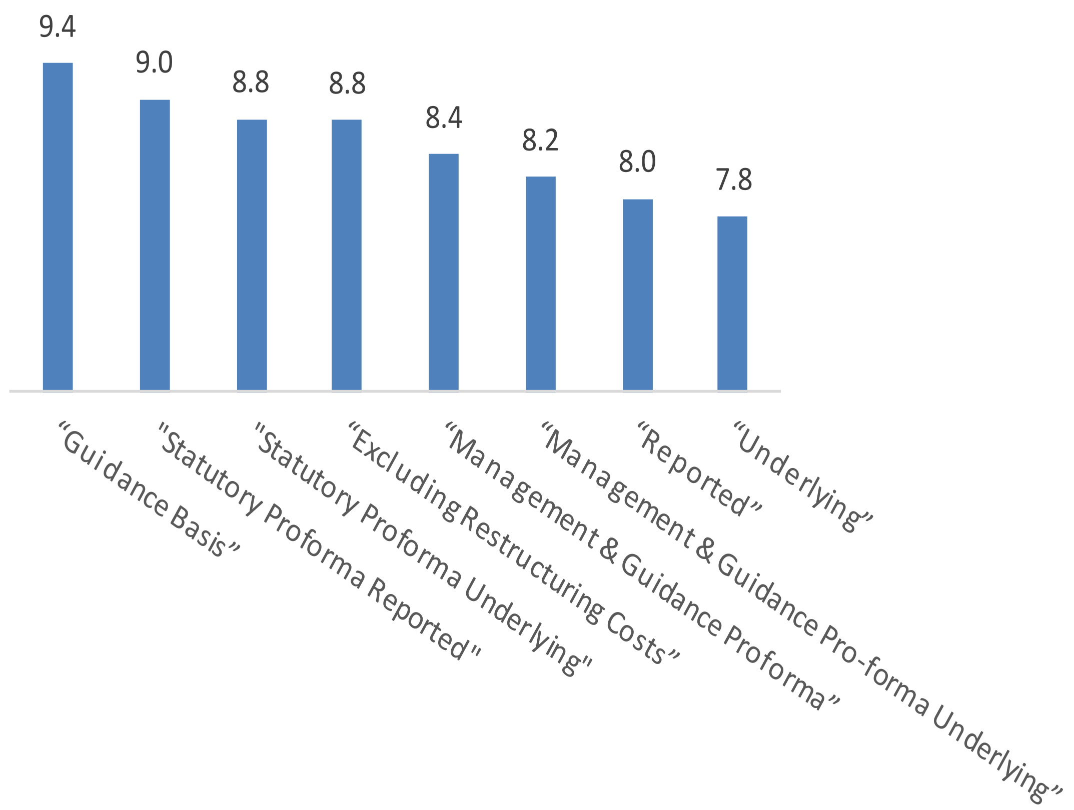
Outline

- ❑ Quality in the Merlon process
- ❑ Why Telstra could be worth less than $2
- ❑ Fund positioning and performance

"Trumpeting EBITDA is a particularly pernicious practice"

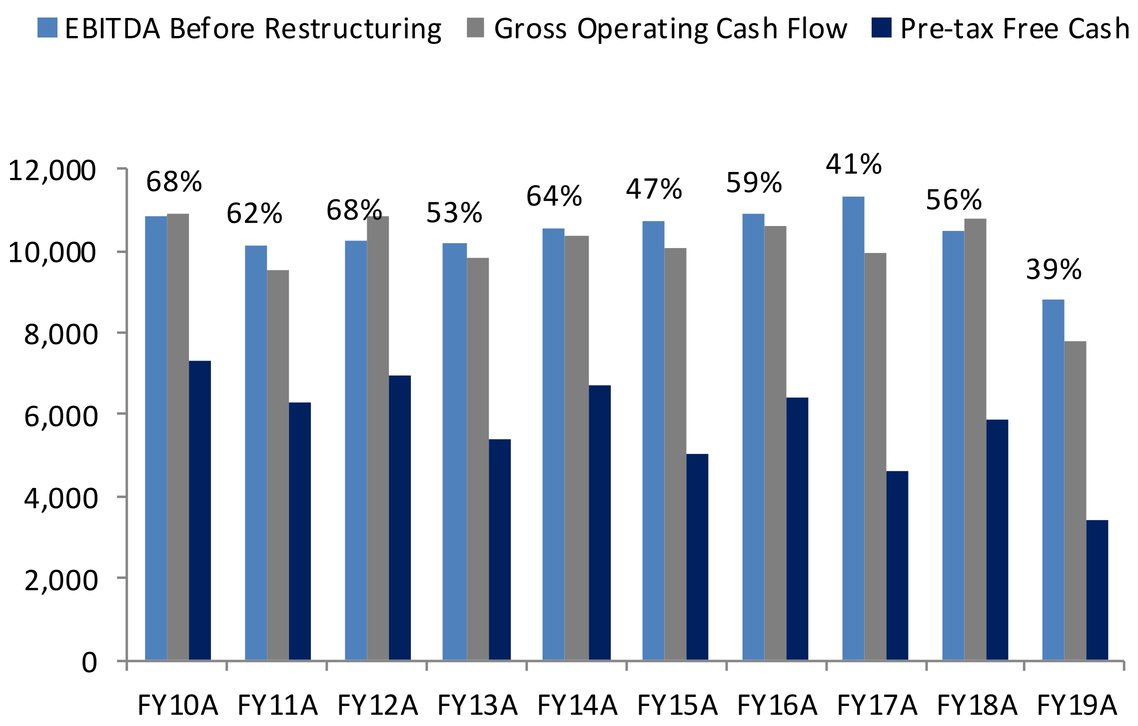
- Berkshire Hathaway 2002 Annual Report (http://www.berkshirehathaway.com/2002ar/2002ar.pdf).

Telstra FY19 "EBITDA" (A$b)



Source: Telstra FY19 Result Presentation. August 2019

Telstra EBITDA, Cash Flow & Cash Conversion



Source: Telstra company Accounts, Cash flow includes cash receipts from asset sales to NBN Co and is net of benefit of $551m from "supply chain finance" in FY19 and benefit of "back-to-back" retail leases. June 2019.

“Unintelligible footnotes usually indicates untrustworthy management”

- Berkshire Hathaway 2002 Annual Report (http://www.berkshirehathaway.com/2002ar/2002ar.pdf).

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Selected Footnotes from Telstra’s FY19 Result Presentation

1. This guidance assumed wholesale product price stability and no impairments to investments or core assets, and excluded any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumed the nbn™ rollout and migration in FY19 was broadly in accordance with the nbn Corporate Plan 2019. The guidance was provided on the basis of AASB15. Capex was measured on an accrued basis and excluded expenditure on spectrum and externally funded capex.
2. Total income excludes finance income.
3. Underlying EBITDA excludes one-off nbn DA receipts less nbn net C2C, and guidance adjustments.
4. In-year nbn headwind defined as the net negative recurring EBITDA impact on our business based on management best estimates.
5. Total dividends of 16 cents per share fully franked comprising total ordinary dividend of 10 cents per share and total special dividend of 6 cents per share.

1. This guidance assumed wholesale product price stability and no impairments to investments or core assets, and excluded any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumed the nbn™ rollout and migration in FY19 was broadly in accordance with the nbn Corporate Plan 2019. The guidance was provided on the basis of AASB15.
2. Total income excludes finance income.

1. Fixed excludes one-off nbn connection income FY19 $106m (FY18 $113m) and includes TUSOPA income FY19 $159m (FY18 $167m). One-off nbn connection income included in one-off nbn DA and connection.
2. Recurring nbn DA restated to include ISA power.
3. Global connectivity includes other income FY19 $5m (FY18 $15m).
4. Other includes media, nbn commercial works (sale of assets), M&A, and miscellaneous.
5. New business includes Telstra Health and Ooyala.
6. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.

1. Product EBITDA restated due to accounting changes and review of fixed cost allocation methodologies to products. Mobile & fixed restated to include International network costs previously included in Other.
2. Fixed includes TUSOPA income FY19 $159m (FY18 $167m).
3. Fixed excludes one-off nbn C2C net of connection income FY19 $362m (FY18 $284m) represented against net one-off nbn DA less net C2C. This includes one-off nbn connection income FY19 $106m (FY18 $113m) and one-off nbn cost to connect (C2C) FY19 $468m (FY18 $397m).
4. Other includes media, nbn commercial works (sale of assets), and miscellaneous.
5. New business includes Telstra Health and Ooyala.
6. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.

1. Working capital movement from operating activities.
2. Includes net investments, interest received, proceeds from lease assets, proceeds on disposal, and non-cash EBITDA items (including impairments and gain on disposal of PP&E).
3. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule. Guidance adjustments include M&A disposals and spectrum.
4. This guidance assumed wholesale product price stability and no impairments to investments or core assets, and excluded any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumed the nbn™ rollout and migration in FY19 was broadly in accordance with the nbn Corporate Plan 2019. The guidance was provided on the basis of AASB15.Capex was measured on an accrued basis and excluded expenditure on spectrum and externally funded capex.
5. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capex and capitalised leases under AASB16 leases.

1. Underlying earnings is defined as NPAT from continuing operations excluding net one-off nbn receipts and guidance adjustments. Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. “net one-off nbn receipts” is defined as net nbn one off Definitive Agreement receipts (consisting of PSAA, Infrastructure Ownership and Retraining) less nbn net cost to connect less tax. FY19 underlying earnings were $2,019m (FY18 $2,582m), net one-off nbn DA receipts less nbn net C2C less tax were $1,129m (FY18 $1,285m), and total guidance adjustments less tax and non-controlling interest were -$994m (FY18 -$276m).
2. The dividend is subject to no unexpected material events, and is subject to Board discretion having regard to financial and market conditions, business needs and maintenance of financial strength and flexibility consistent with Telstra’s capital management framework.
3. FY18 payout ratios have been restated consistent with restatement of earnings based on AASB15 and underlying earnings definition. Ordinary dividend payout ratio including guidance adjustments was 116% in FY19 (77% FY18).
4. “Life to date” defined as since beginning FY18 and implementation of new dividend policy with restated earnings based on AASB15.

1. Represents position after hedging based on accounting carrying values. Gross debt comprises borrowings and derivatives.
2. Represents gross interest cost on gross debt.
3. Debt servicing calculated as net debt over EBITDA. Gearing calculated as net debt over total net debt and equity. Interest cover calculated as EBITDA over net interest expense (excluding capitalised interest and revaluation impacts on our borrowings and derivatives).
4. Capex was measured on an accrued basis and excluded expenditure on spectrum and externally funded capex.
5. ROE is calculated at PATMI as a percentage of equity.
6. ROIC calculated as NOPAT as a percentage of total capital. Underlying ROIC calculated as NOPAT excluding net one-off nbn DA less C2C and guidance adjustments less tax as a percentage of total capital. Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. Historical numbers restated based on updated definition and - underlying ROIC including guidance adjustments 5.0% (FY18 9.1%)
7. This estimate is illustrative only and actual impacts will depend on final accounting interpretations and assumptions. See ‘AASB16 “leases” FY19 Proforma & FY20 indicative impacts” slide
8. Post-nbn defined as FY23 and beyond on AASB16 basis

1. Impacts shown are based on a projection of current lease portfolios and provided to give a directional sense of the quantum. Actual impacts may differ from numbers shown.
2. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.
3. Finance costs also relate to mobile swap.
4. This estimate is illustrative only and actual impacts will depend on final accounting interpretations and assumptions

1. This guidance assumes wholesale product price stability and no impairments in and to investments or property, plant and equipment and intangible assets, and excludes any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumes the nbn rollout and migration in FY20 is broadly in accordance with the nbn Corporate Plan 2019. Guidance is provided on the basis of AASB16 Leases and assumes impacts consistent with management estimates and current interpretation of the standard. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capex and capitalised leases under AASB16 Leases.
2. Excluding finance income.
3. Underlying EBITDA excludes net one-off nbn DA receipts less nbn net C2C, guidance adjustments and includes amortisation of mobile operating lease costs.
4. In-year nbn headwind defined as the net negative recurring EBITDA impact on our business based on management best estimates including key input of the nbn Corporate Plan 2019.
5. FY20 free cashflow defined as operating cash flows less investing cash flows less operating leases (reported in financing cash flow under AASB16 Leases).
6. FY20 free cashflow guidance includes ~$1b working capital increase including from exit of mobile lease plans, remaining outflows from restructuring costs announced in May 2019, and an increase in nbn receivables

1. Underlying earnings is defined as NPAT from continuing operations excluding net one-off nbn receipts (as defined in footnote 2) and guidance adjustments.Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum.
2. “net one-off nbn receipts” is defined as net nbn one off Definitive Agreement receipts (consisting of PSAA, Infrastructure Ownership and Retraining) less nbn net cost to connect less tax.
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1. Product operating expenses restated due to accounting changes and review of fixed cost allocation methodologies to products.
2. Fixed excludes one-off nbn cost to connect (C2C) FY19 $468m (FY18 $397m). One-off nbn C2C included in one-off nbn DA and nbn C2C.
3. Recurring nbn DA restated to include ISA power.
4. Other includes media, nbn commercial works (sale of assets), and miscellaneous.
5. New business includes Telstra Health and Ooyala.
6. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.

1. TUSOPA is run by Department of Communications and the Arts and the income is net of the levy paid.
2. Included as sales revenue. Restated to include ISA power.
3. Included as other income.
4. Included as other income. Includes receipts for assets transferred under the nbn Definitive Agreements (DAs). Restated to exclude ISA power.
5. included as other income. Includes income from nbn disconnection fees (Per Subscriber Address Amount (PSAA)).
6. nbn commercial works – products and services revenue is recognised as NAS revenue.

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7. This estimate is illustrative only and actual impacts will depend on final accounting interpretations and assumptions. See ‘AASB16 “leases” FY19 Proforma & FY20 indicative impacts” slide
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Source: Telstra FY19 Result Presentation. August 2019

“Be Suspicious of Companies that Trumpet Earnings Projections”

- Berkshire Hathaway 2002 Annual Report (http://www.berkshirehathaway.com/2002ar/2002ar.pdf).

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Telstra 2020 Analyst Guidance

FY20 guidance

	FY19	FY20 guidance[1] Based on new accounting standards
Total income[2]	$27.8b	$25.7b to $27.7b
Underlying EBITDA[3] - Included in-year nbn headwind[4]	**$8.2b**	**$7.3b to $7.8b** ~-$0.8 to ~-$1.0b
Net one-off nbn DA receipts less nbn net C2C	$1.6b	$1.6b to $2.0b
Restructuring costs	$0.8b	~$0.3b
Capex	**$4.1b**	**$2.9b to $3.3b**
Free cashflow after operating lease payments[5,6]	**$3.1b**	**$3.4b to $3.9b**

	Range	
FY20 Underlying EBITDA movement	-$0.9b	-$0.4b
Excluding approximate in-year nbn headwind	$0.9b	$0.9b
Growth ex-nbn headwind	$0b	+$0.5b

1. This guidance assumes wholesale product price stability and no impairments in and to investments or property, plant and equipment and intangible assets, and excludes any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumes the nbn rollout and migration in FY20 is broadly in accordance with the nbn Corporate Plan 2019. Guidance is provided on the basis of AASB16 Leases and assumes impacts consistent with management estimates and current interpretation of the standard. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capex and capitalised leases under AASB16 Leases.
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Source: Telstra FY19 Result Presentation. August 2019

Valuation

Implied Telstra Valuation Based on Simple Price / Earnings Ratio

	Low	High
FY19 underlying basic earnings per share	$0.17	$0.17
Less: Fixed line contribution	($0.08)	($0.05)
FY19 EPS excluding fixed line	**$0.09**	**$0.12**
Price/Earnings ratio	15x	20x
Implied valuation based on simple price/earnings ratio	**$1.35**	**$2.40**

Source: Source: Telstra FY19 Result Presentation, Merlon Analysis September 2019

Outline

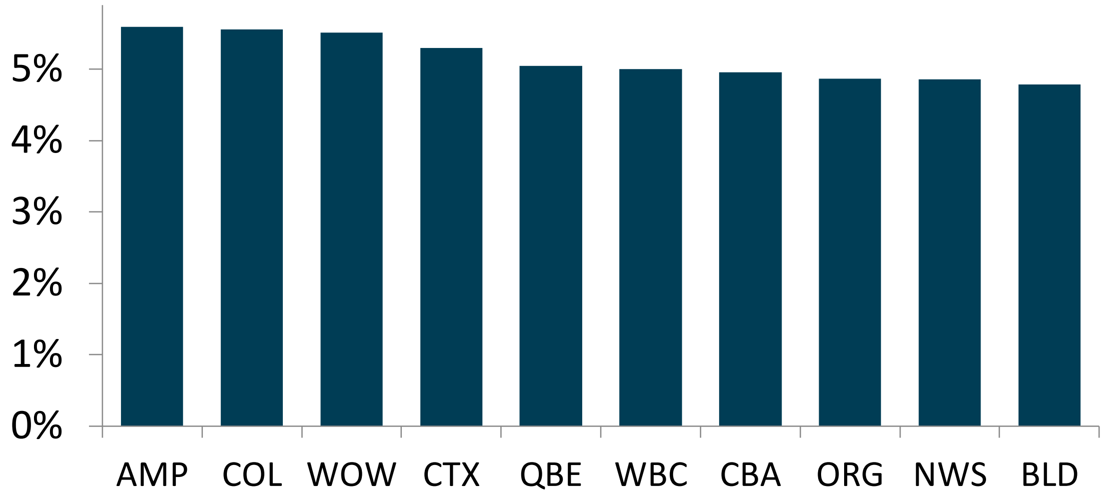
- Quality in the Merlon process
- Why Telstra could be worth less than $2
- Fund positioning and performance

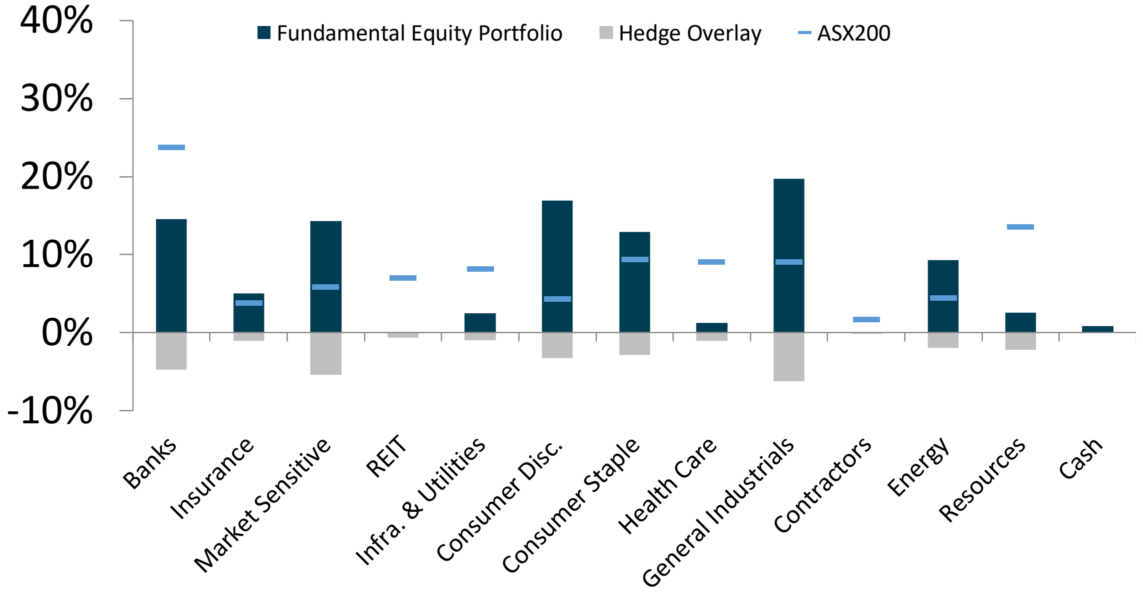
Merlon Australian Share Income Fund Performance

	FY20TD (%)	FY2019 (%)	FY2018 (%)	FY2017 (%)	FY2016 (%)	FY2015 (%)	FY2014 (%)	FY2013 (%)	FY2012 (%)	3 Years (% pa)	5 Years (% pa)	7 Years (% pa)
ASX200 Return	2.8	13.2	14.5	15.5	2.2	7.2	18.9	24.3	-5.1	13.4	11.0	12.5
Share Portfolio Excess Return	1.5	-4.8	-6.9	8.0	4.8	2.3	-2.7	11.7	1.7	-2.7	0.1	1.7
Hedge Overlay	-0.4	-0.9	-2.4	-5.6	-0.9	-1.7	-3.5	-9.3	2.6	-2.1	-2.1	-3.0
Portfolio Return (before fees)	3.9	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	8.6	9.0	11.2
Portfolio Return (net of fees)	3.7	6.5	4.2	16.8	5.1	6.8	11.8	25.5	-1.7	7.6	8.0	10.2
Gross Yield	1.9	7.9	7.0	7.8	7.5	7.6	7.6	9.8	10.1	7.4	7.6	7.8
Average Daily Market Exposure	67%	69%	68%	68%	70%	70%	69%	69%	69%	68%	69%	69%

Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated as at 30 September 2019. Past performance is not a reliable indicator of future performance.
Gross Distribution Yield represents the income return of the fund inclusive of franking credits (before fees).

Merlon Australian Share Income Fund - Current Fund Positioning



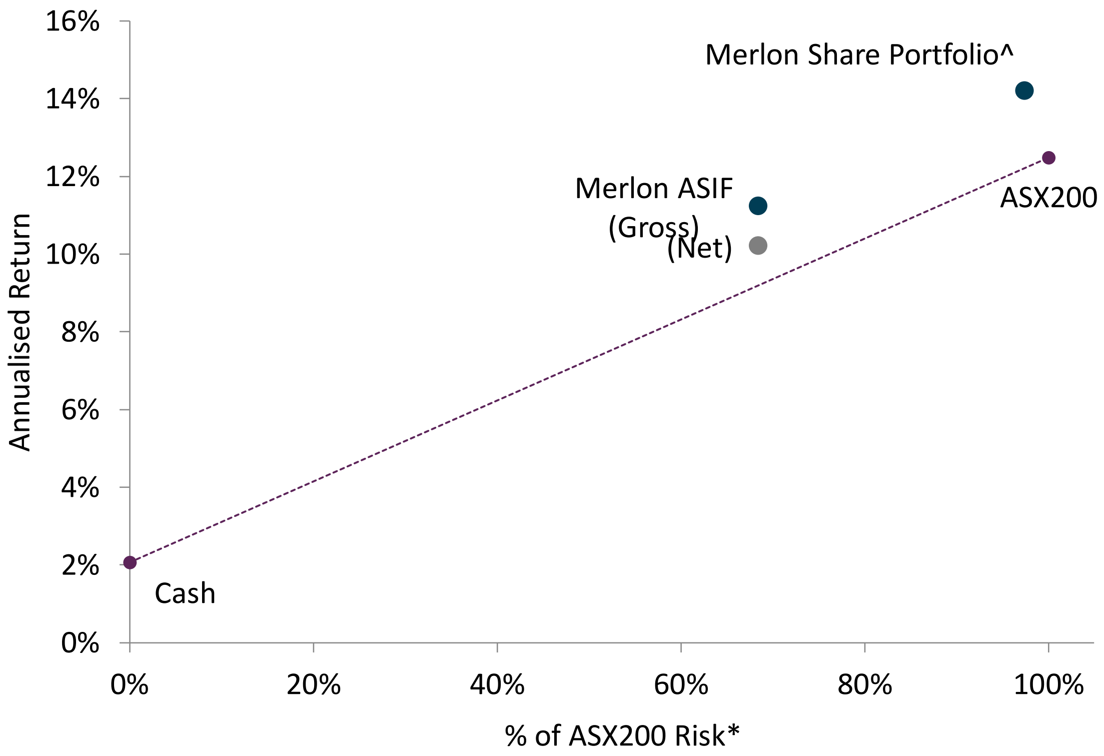


Portfolio Analytics – 30 September	Portfolio	ASX200
Number of Equity Positions	33	200
Net Market Exposure	69%	100%
Active Share	77%	0%
Valuation Upside[1]	19%	-18%
Trailing Free Cash Yield	6.1%	4.4%
Gross Distribution Yield	6.8%	5.2%
Price / Earnings Ratio	16.0x	18.7x

Portfolio as at 30 September 2019. [1]Valuation Upside based on Merlon proprietary valuations.

Outcomes

Total Return vs Risk (7 Years)



Monthly Distribution Detail: Cents per Unit

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total	Franking
FY2013	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.29	**6.79**	2.26
FY2014	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.52	**6.13**	1.98
FY2015	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	**6.24**	2.20
FY2016	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	**6.35**	1.92
FY2017	0.53	0.53	0.53	0.53	0.53	0.3	0.53	0.53	0.53	0.53	0.53	0.53	**6.36**	2.02
FY2018	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	**6.35**	1.84
FY2019	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.50	***6.33***	*2.57*
FY2020	0.51	0.51	0.51	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*6.12*	*1.80*

Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated net or gross of fees (as applicable) as at 30 September 2019.
Merlon Australian Share Income Fund franking 1.9% p.a., ASX200 franking 1.5% p.a.
*% of ASX200 Risk represents the Fund's statistical beta relative to the ASX200. Past performance is not an indication of future performance.
^Underlying portfolio returns before hedge overlay

Forecast distribution estimates are based on Merlon's conservative best estimate of dividends over the upcoming 12 months and implied cash yields earned on hedging activity based on the portfolio composition as at the date of this document. Merlon constantly monitor these estimates through their underlying assessment of forecast free cash-flow from portfolio companies and how this translates to dividends to equity holders based on historical and forward looking analysis. Information is predictive in nature, may be affected by inaccurate assumptions or known or unknown risks and uncertainties, and may differ materially from results achieved. Results are not guaranteed.

How Merlon's Approach is Different

MERLON CAPITAL PARTNERS

Fundamental Research

Focused on sustainable cash flow

Portfolio Diversification

No reference to ASX200 weights

Downside Protection

Through research & hedge overlay

This focus on capital preservation and growth delivers

Sustainable Income

Paid monthly and majority franked

A bit more about your presenters

Hamish Carlisle
Analyst/Portfolio Manager

Hamish joined Merlon Capital Partners as a Principal in July 2010. Hamish was previously Head of Research, Asia Pacific Equities at AMP Capital Investors. Prior to AMP, Hamish was a Senior Director and Head of Australian Banks Research at Merrill Lynch Equities. He has also held positions at Burdett, Buckeridge, Young and National Australia Bank.

Hamish holds a MBA with honours from The Wharton School, University of Pennsylvania. Hamish holds a B.Comm (Hons) and an MBA (Hons).

Adrian Lemme
Analyst/Portfolio Manager

Adrian joined Merlon Capital Partners as a Principal in May 2012 from AMP Capital where he was a Portfolio Manager/Analyst, responsible for investments in retail, food and beverage, transport and chemical sectors. Having commenced his career with Commonwealth Bank in 2003, Adrian was the lead transport analyst with CBA Equities Research prior to joining AMP Capital in 2010.

Adrian holds a BMathFin (Hons) and CFA.

Joey Mui
Analyst/Portfolio Manager

Joey Mui joined Merlon Capital Partners as an Portfolio Manager/Analyst in April 2016. Prior to Merlon, Joey was a Portfolio Analyst for AMP Capital Multi-Strategy equity funds responsible for investments in the real estate sector in Australian and Asian equities. He also completed internships in the Equity Research teams at JP Morgan and Nomura.

Joey holds a B.Comm (Distinction) and CFA.

Thank you